MEMORANDUM

To: Dr. Jim Yong Kim
From: Matthew Samach
Subject: Lessons on economic development from South Korea and applications to Mexico
Date: November 6, 2018

Abstract

This paper is will analyze South Korea's developmental strategy that led to equity and prosperity over the past 60 years. Three primary dimensions of this strategy will be discussed: prioritization of exporting industrial goods, building domestic integration within the industrial sector, and heavily supporting small and medium sized enterprises. It will then give recommendations, based on these focuses, that the World Bank development fund can apply to Mexico in order to bring robust and equitable economic growth to that country.

South Korean Developmental Philosophy

Equitable economic growth has been a conscious goal of the South Korean state since its inception. The Constitution of the First Republic (1948) explicitly called for the "development of a balanced national economy that can satisfy the needs of its citizens.[1]" Equality and improved living standards have been secured through state interventionist policies focused on full employment, even development, and a strong focus on export goods.[2]

Results in terms of both growth and equity have been exceptional. Between 1965 and 1980, South Korea experienced a staggering 7% growth rate.[3] Between 1985 and 1989, it had an even more impressive 10% growth rate.[4] Poverty declined from 41.4% to 14.6% of the population between 1965 and 1975.[5] Finally, real wages grew at an average annual rate of 10% throughout most of the 1980s.[6]

Analysis of South Korean Economic Policy

Prioritization of Export Markets

Soon after assuming power in 1961, President Park Chung-Hee initiated an ambitious industrialization drive with a heavy focus on export markets. His government would establish several agencies to achieve this goal and a state monopoly on banking allowed for a alignment of investment with these bureaucracies. The Economic Planning Board allocated foreign and domestic credit to industries that it deemed favorable for export markets. The Trade Promotion Agency conducted research on international export markets, capital and technology.[7]

Park's government could coerce the *chaebols* (massive Korean conglomerates) to meet export targets and construct factories in industries the state deemed favorable by offering them low-interest loans and loan guarantees.[8] The state originally prioritized heavy industrial sectors like fertilizers but changed course to labor-intensive sectors like textiles and electrical appliances because of their surprising profitability. By the late 1960s, it switched focus to heavy and chemical sectors like iron, steel, and industrial chemicals.[9]

State direction of the economy towards exports was extremely successful in these early years. By 1968, exports were 14 times higher than in 1960. Over the same duration, the share of manufactured products in total exports increased from approximately 10 percent to almost 75 percent. Employment in the manufacturing sector rose from 6.8 percent in 1960 to 21.7 percent in 1980 and the percentage of GDP attributable to manufacturing was 27 percent by 1980.[10]

The state would still play an active but decreasing role in promoting export performance into the 1980s. The administration of Major General Chun Doo Hwan forced the merger of heavy and chemical private firms in an effort to increase their global competitiveness.[11]

Following a financial crisis in 1997, South Korea signed an agreement with IMF which stipulated neoliberal policies such as deregulation, privatization, and trade liberalization.[12] Increasingly strict international trade rules meant that the state had to take up less hands-on methods for encouraging exports – it established the Export Insurance Fund and engaged in duty drawbacks to stimulate exports while avoiding violating WTO or OECD guidelines.[13]

Integrated Industrial Planning

Under President Park, the strength of the state allowed it to coordinate economic planning across industries. Loans and loan guarantees dispersed by the Bank of Korea and Korean Development Bank, both centrally controlled apparatuses, gave the government the power to pick "winners" in the economy - provided they were compliant with state demands.[14]

Another small but important tool of state control of the economy was industrial public enterprises. In 1972, these numbered only 100 and produced 9% of GNP.[15] These firms existed solely to catalyze and support economic development. For instance, the state steel company was able to provide cheap steel to the private sector.

All these levers of control allowed the state to create a highly integrated manufacturing sector.[16] An integrated economy is one in which many inputs to production are sourced from the same country as the producing firm. A robust, integrated domestic supply sector can have many positive effects: increased regional employment, conservation and distribution of benefits of scarce foreign trade, and dynamic competitive advantages.[17] Linkages often bring positive externalities as domestic markets are strengthened from increased employment and domestic suppliers gain technical savvy and increased scale.

One example of a deliberate linkage is the aforementioned public steel company with construction and metal industries. Shipbuilding was one of South Korea's most prominent export sectors. The establishment of the state steel company allowed the shipbuilding industry to move from international sourcing of 100 percent of its steel plates before 1966 to only 27 percent by 1976.[18] When state owned companies were not feasible, the government would foster the development of new private domestic suppliers. The government did exactly this when it encouraged the creation of a synthetic fiber industry to supply textile manufacturers.[19]

After the country's neoliberal reforms in 1997, the South Korean government's ability to direct the economy was greatly curtailed. The primary method of state influence still available is the allocation of funds or other resources to certain sectors. In the early 2000s, President Kim Dae Jung's administration provisioned infrastructure to emerging firms in the information technology industry.[20]

Support for Small and Medium Enterprises

Small and Medium Enterprises (SMEs) are important employment generating firms in most developing countries. Given the South Korean government's goal of full employment through most of its history, it's unsurprising that support for SMEs has been a staple of economic policy.

One of the earliest schemes to grow SMEs was the Chun regime's expansion of credit for small firms in the 1980s.[21] The Roh administration of the late 80s provided even more direct material support to SMEs. He created funds to help SMEs with adopting advanced technologies and provided substantial tax exemptions.[22] These programs proved very effective at stimulating the SME sector. The share of total employment in the SME sector increased from 49.6 percent to 69.2 percent between 1980 and 1996; the share of total exports from SMEs increased from 31.2 to 41.8 percent.[23]

Even in the early years of economic liberalization, the Korean state continued with aggressive measures to support the SME sector. President Kim Young Sam, in a drastic push for growth, oversaw a doubling of financial support for SMEs in 1994. He mandated that banks allocate 45 percent of annual loan increases to SMEs and established the Agency for Small and Medium Industry.[24] These aggressive measures paid off. In 1997, SMEs were responsible for 69 percent of total employment and 42.9 percent of total exports.[25]

The 2000s were marked by continued indirect state support for SMEs. Several programs were instituted to increase SME competitiveness – a half billion US dollar export fund aided firms with marketing and technology development. In 2006, SME manufacturing firms provided 87.5 percent of employment in manufacturing and 35.6 percent of exports.[26]

The Mexican Case and Policy Recommendations

Mexico has employed a variety of economic frameworks over its tumultuous history. After declining international petroleum prices and excessive foreign debts caused an economic crises in the early 1980s, Mexican policymakers moved from an import-substitution and petroleum export model to the neoliberal Washington Consensus.[27] This ideology posits that the state's only constructive role in economic development is to promote trade and remove barriers that prevent markets from efficiently allocating resources – distortions like state regulations, state or private monopolies, and tariffs must all be eliminated.[28]

These liberal policies were successful for securing macroeconomic stability but failed to produce robust growth or employment. From 1982 to 2010, the economy only grew an average of 2.1 percent annually. GDP growth per capita over the same period has been a dismal 0.46 percent.[29] Although Mexico has been able to increase its share of industrial products as exports - in 2008 industrial products represented 82 percent of exports - employment in the sector has lagged due to the industrial sector's lack of integration with other actors in the economy.[30]

To generate employment and reduce poverty in Mexico, the World Bank should finance two broad policy packages – one centered on integrating the Mexican economy with maquilas (special exporters) and one centered on growth of small and medium sized enterprises.

Recommendation 1: A set of policies to induce the integration of domestic suppliers with maquilas. Maquilas are special exporting economic zones established in 1965 to promote employment in the north border region and accelerate technology adoption.[31] While this program has been successful in a narrow sense - it has attracted foreign companies and increased industrial exports – it has failed to uplift local economies broadly.

First, the World Bank should establish a fund to provide financial aid (loan guarantees, subsidized interest, low interest loans on working capital) to domestic suppliers for some of the major maquila sectors. Helping these suppliers build scale can entice maquiladoras to choose them over foreign competitors when it comes to large orders. Three of the largest maquila sectors are textiles, electronics, and automobiles.[32] The fund should focus on suppliers of synthetic fibers, computer chips, and automotive parts to meet this need.

Second, the World Bank should help the Mexican government provide incentives for Maquiladoras to use local suppliers. Two mechanisms that achieve this are tax credits and increasing permissible sales within Mexico for partnering with domestic firms.[33]

Recommendation 2: A set of policies to support the growth of small and medium sized enterprises (SMEs). These policies define SMEs as firms with 300 employees or less.

First, the World Bank should help the Mexican government expand financial support programs (loan guarantees, subsidized interest, and tax exemptions) to SMEs.

Second, the Mexican government should establish an agency that assists SMEs with marketing and adopting advanced technology. This agency can also provide outreach and assistance with repair and maintenance of industrial equipment. This program would help small firms increase useful life of capital, cut costs, and improve efficiency through reduced downtime.

Finally, the World Bank should incentivize sharing of capital among SMEs. It can do this in two ways. The first is to help establish markets for secondhand industrial equipment. This approach worked well in Colombia during a period of rapid SME growth.[34] Second, the government can offer tax incentives for the construction of industrial parks. Having firms concentrated geographically can increase sharing of capital and knowledge.[35]

Conclusion

The South Korean state has shown a path to economic prosperity for middle income countries. By using interventionist policies focused on expanding foreign exports, integrating industrial supply chains, and growing the small and medium enterprise sector, the state was able to provide employment and prosperity for the majority of its citizenry. The World Bank should use its development fund to help Mexico adopt these approaches. It should incentivize maquilas to use domestic suppliers for inputs and support the growth of input sectors to maquila industries. This policy would build integrations within the Mexican economy, boosting employment and better distributing the positive effects of an already successful industrial export strategy. It should also increase support for small and medium enterprises by boosting financial support for the sector, establishing an agency to assist firms with capital stretching, marketing and technology adoption and incentivizing capital sharing between firms.

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[1] Teichman, Judith A. Social Forces and States: Poverty and Distributional Outcomes in South Korea, Chile, and Mexico. Stanford, CA: Stanford University Press, 2012, 34.
[2] Ibid, 33.
[3] Ibid, 26.
[4] Ibid, 133.
[5] Ibid, 26.
[6] Ibid, 134.
[7] Ibid, 39.
[8] Ibid, 41.
[9] Ibid, 41.
[10] Ibid, 42.
[11] Ibid, 133.
[12] Ibid, 144.
[13] Ibid, 137.
[14] Ibid, 41.
[15] Ibid, 40.
[16] Ibid, 42.
[17] Brannon, Jeffery T., Dilmus D. James, and William Lucker. "Generating and Sustaining Backward Linkages Between Maquiladoras and Local Suppliers in Northern Mexico." World Development 22, no. 12 (1994): 1933-945.
[18] Teichman, Judith A. Social Forces and States: Poverty and Distributional Outcomes in South Korea, Chile, and Mexico. Stanford, CA: Stanford University Press, 2012, 42.
[19] Ibid, 42.
[20] Ibid, 144.
[21] Ibid, 134.
[22] Ibid, 135.
[23] Ibid, 135.
[24] Ibid, 137.
[25] Ibid, 137.
[26] Ibid, 144.
[27] Calderón, Cuauhtémoc, and Isaac Sánchez. "Economic Growth and Industrial Policy in Mexico." Revista Latinoamericana De Economia 43, no. 170 (July/August 2012).
[28] Ibid.
[29] Ibid.
[30] Teichman, Judith A. Social Forces and States: Poverty and Distributional Outcomes in South Korea, Chile, and Mexico. Stanford, CA: Stanford University Press, 2012, 158.
[31] Brannon, Jeffery T., Dilmus D. James, and William Lucker. "Generating and Sustaining Backward Linkages Between Maquiladoras and Local Suppliers in Northern Mexico." World Development 22, no. 12 (1994): 1933-945.
[32] Castillo, Juan Carlos, and Gaaitzen De Vries. "The Domestic Content of Mexico's Maquiladora Exports: A Long-run Perspective." The Journal of International Trade & Economic Development 27, no. 2 (July 24, 2017): 200-19.

[33] Brannon, Jeffery T., Dilmus D. James, and William Lucker. "Generating and Sustaining Backward Linkages Between Maquiladoras and Local Suppliers in Northern Mexico." World Development 22, no. 12 (1994): 1933-945.
[34] Ibid.
[35] Ibid.